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No. 288

In the Supreme Court of the United States

OCTOBER TERM, 1960

AMERICAN AUTOMOBILE ASSOCIATION, PETITIONER

v.

UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (R. 51–71) is reported at 181 F. Supp. 255.

JURISDICTION

The judgment of the Court of Claims was entered on March 2, 1960. (R. 51.) The order denying the taxpayer's motion for rehearing and for amendment of findings of fact and conclusion of law was entered on May 4, 1960. (R. 82.) The petition for a writ of certiorari, filed on August 2, 1960, was granted on October 10, 1960. (R. 83.) The jurisdiction of this Court rests upon 28 U.S.C. 1255.

QUESTION PRESENTED

Whether the court below correctly sustained the Commissioner's determination that the taxpayer, filing its income tax returns on the calendar year-accrual basis, was required to report annual membership dues as gross income in the respective taxable years in which the dues were received, undiminished by a contingent liability reserve set up on taxpayer's books to reflect estimated expenses which it anticipated would be incurred in a subsequent year in performing services for its members.

STATUTES AND REGULATIONS INVOLVED

The statutes involved are Sections 21(a), 22(a), 23(a)(1)(A), 41, 42(a), 43, and 48 (a) and (c), Internal Revenue Code of 1939; Sections 61, 63(a), 162(a), 441 (a) through (e), 446, 451(a), and 461(a), Internal Revenue Code of 1954. See Appendix, *infra*, pp. 1a–7a.

The Regulations involved are Treasury Regulations 118 (1939 Code), Sections 39.41–1, 39.41–2, 39.41–3, 39.41–4, 39.42–1(a), 39.42–4, 39.43–1(a), and 39.43–2; Treasury Regulations on Income Taxes (1954 Code), Sections 1.441–1, 1.446–1, 1.451–1(a), 1.451–3, and 1.461–1(a). See Appendix, *infra*, pp. 7a–30a.

STATEMENT

The material facts, as found by the Court of Claims (R. 51–54, 58–71), may be summarized as follows:

The taxpayer, a national automobile club having its principal office in Washington, D.C., was organized under the laws of Connecticut in 1910 as a non-stock,

membership corporation. In addition to services provided affiliated local automobile clubs and their members, the taxpayer directly operates ten local automobile clubs as divisions. (R. 58.)

A substantial portion of the taxpayer's annual gross income is derived from dues, paid one year in advance by members of the ten local automobile clubs. The taxpayer provides these members services which, although not completely uniform in every division, generally include: (a) a complete travel service including trip planning, tour books, accommodation directories, maps and recommended routes; (b) emergency road service (towing, changing tires, replacing batteries and other minor repairs), through contracts made with garages and service stations; (c) bail bond protection up to $5,000, through contracts made with bondsmen; (d) personal automobile accident insurance, through the purchase of group insurance policies; (e) a theft reward for information leading to the arrest and conviction of any person stealing a member's car. In addition, the taxpayer, in one or more of its divisions, provides other personal services such as procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts. (R. 58–59.)

Commencing with 1943, the taxpayer has been required to file federal income tax returns and to pay federal income taxes. The taxpayer employs an accrual method of accounting in keeping its books and filing its returns, and uses the calendar year as its

taxable year. (R. 59–60.) The method of accounting employed by the taxpayer during the years in issue has been used regularly by it since 1931 and is in accord with generally accepted commercial accounting principles. (R. 66.)

The dues received by the taxpayer from its members were deposited in the taxpayer's bank accounts, with no restrictions as to their use for any corporate purpose. (R. 63, 68.)

Under the method of accounting employed by the taxpayer during the years in issue, the dues received from members were not regarded entirely as income in the calendar year of receipt, but, instead, were treated as income received ratably over the twelve-month membership period even though such period extended beyond the close of the taxable year. As of December 31 of each taxable year, the percentage of dues collected within the taxable year, which the taxpayer considered applicable to memberships extending beyond the close of the year, was recorded as a liability of the taxpayer and was so reflected on the balance sheet accompanying its income tax return. Expenses which the taxpayer considered as prepaid membership costs were not deducted entirely in the taxable year paid or incurred, but were deducted ratably over the same period of time that dues were recognized as income. (R. 62.)

During the years from 1931 through 1953, dues collected in any month of the calendar year were included in income to the extent of one-twenty-fourth thereof in the month when the collections were made, one-twelfth in each of the succeeding eleven months,

and the remaining one-twenty-fourth in the last month, when the membership expired. The liability account which the taxpayer maintained on its books in order to reflect that portion of its monthly collections which were not included in income as of the close of the taxable year was entitled "Deferred Revenue Membership Dues", or some similar title. (R. 63–64.)

In 1954, in order to simplify its accounting system, the taxpayer changed its procedure by assigning 50 per cent of its annual collections to income for the current year and the remaining 50 per cent to the liability account, to be recognized as income in the following year. The taxpayer also revised its method of allocating some of its expenses. (R. 65.)

For the calendar years 1949 through 1954, the percentage of gross income from membership dues which taxpayer reported as income in the year of receipt, and the percentage deferred until the following taxable year, were as follows (R. 65):

	Portion recognized as income during the year collected	Portion remaining in the liability account Dec. 31 and treated as income the following year
1949	48.9%	51.1%
1950	50.0%	50.0%
1951	51.3%	48.8%
1952	52.0%	48.0%
1953	50.3%	49.7%
1954	50.0%	50.0%

The taxpayer's actual average cost per member in each month of the calendar years 1953 and 1954, and

the percentage of monthly costs to total costs for each month over the respective five-year periods preceding 1953 and 1954, were as follows (R. 71):

Month	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period
	Amount	Percent of cost for year		Amount	Percent of cost for year	
January	$1.12	7.71	7.46	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.44	1.37	9.27	8.44
April	1.32	9.15	8.83	1.24	8.41	8.83
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.90	1.34	9.12	8.98
August	1.23	8.52	8.56	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.64
December	1.10	7.59	8.20	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

The following table (R. 69) shows the percentage of annual receipts from membership dues that would have been recognized as income in the year of receipt, and the remaining percentage that would have been deferred to the following year, had the taxpayer allocated its monthly receipts in proportion to its average monthly cost per member in each month of 1953 and 1954, or in proportion to average monthly costs over the respective five-year periods preceding 1953 and 1954, instead of allocating those receipts ratably over the membership period of twelve months:

	Plaintiff's pro rata method as reported	Average monthly costs for current year	Average monthly costs over prior 5-year period
1953			
Apportioned to gross income during current year	50.3%	49.8%	50.4%
Deferred to the following year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to gross income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

In its 1953 tax return, the amount of income reported by the taxpayer as attributable to dues receipts was $3,337,813.44, representing $1,562,042.23 of dues collected in 1952 but deferred as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year. In its return for 1954, the taxpayer reported dues income of $3,794,672.20, representing $1,755,407.46 of dues collected in 1953, but deferred as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year. (R. 66.)

Upon examination of the taxpayer's returns for 1952, 1953 and 1954, the Commissioner refused to recognize the deferral of income from one year to another for years subsequent to 1952, and also adjusted deductions taken for prepaid membership costs. The net effect of this determination was to increase the taxpayer's 1953 net income from $353,279.09 to $481,557.59 and to reduce its 1954 net operating loss from $289,967.67 to $14,412.49. As a consequence, a claimed net operating loss carryback from 1954 to 1952 was reduced, and a claimed net

operating loss carryback to 1953 was eliminated. These adjustments resulted in deficiencies in the amount of $58,083.58 for 1952 and $137,907.48 for 1953. The taxpayer paid these deficiencies, together with interest, and filed timely claims for refund, which were disallowed. (R. 60–62.) Taxpayer then sued for refund, and the Court of Claims sustained the Commissioner's determination.

SUMMARY OF ARGUMENT

The taxpayer's members paid annual membership dues in advance, and taxpayer received this income without restriction as to its use, depositing the funds in its general bank account. On its books, the taxpayer credited the dues received to a liability account designated "deferred revenue", as a reserve for estimated future expenses of performing services for its members, and monthly thereafter it transferred from this account one-twelfth of the amount of dues received to an "income" account. In filing its federal income tax returns on the calendar year and accrual basis, taxpayer reported as gross income only that portion of the dues collected which corresponded to the number of months falling within the taxable year (the amount reflected in the "income" account), and allocated the balance (the amount reflected in the "deferred revenue" account) to the following year.

I

The Court of Claims correctly sustained the Commissioner's determination that taxpayer was required to report as gross income the entire amount of mem-

bership dues received in the years received, without offset for estimated expenses anticipated in a later year (treated by taxpayer as "unearned" or "deferred" income). Under long established tax accounting principles embodied in the Internal Revenue Code, repeatedly reaffirmed by this Court and applied by the Tax Court and other courts, net taxable income (defined in the Code as gross income less allowable deductions for a given taxable year) must be computed and reported on an *annual* rather than on a *transactional* basis. *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Brown* v. *Helvering*, 291 U.S. 193. This means that neither items of gross income nor items of deduction may be postponed or accelerated from one taxable year to another in order to reflect the income ultimately to be derived from a given transaction or group of transactions, irrespective of whether the taxpayer employs the cash or the accrual method of accounting. As applied to taxpayers using the accrual method, the annual accounting rule precludes the allocation of an item of gross income to any year other than that in which the right to receive it becomes fixed, which can be no later than the year in which it is actually received without restriction as to its use. *Security Mills Co.* v. *Commissioner, supra; Spring City Co.* v. *Commissioner*, 292 U.S. 182; *Commissioner* v. *Hansen*, 360 U.S. 446; *United States* v. *Lewis*, 340 U.S. 590. Conversely, an item of deduction (expense, loss, etc.) may be offset against gross income only in the year in which the liability to pay becomes fixed, *i.e.*, when all the events have occurred which determine both the fact and amount of the

liability. *Brown* v. *Helvering, supra; United States* v. *Anderson,* 269 U.S. 422; *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516.

The underlying purpose of the annual accounting system, as this Court has frequently pointed out, is to assure the government, through methods of accounting and collection capable of practical operation, an ascertainable amount of revenue at regular intervals. *E.g., Security Mills Co.* v. *Commissioner, supra; Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359. The only exceptions to the rule are those provided in the Internal Revenue Code itself and the Treasury Regulations, and, as observed in the concurring opinion below, neither the gross income nor the deductions with which we are here concerned come within any of the exceptions. This Court has properly refrained from carving out additional exceptions which Congress itself has not seen fit to enact. Moreover, the legislative history surrounding the enactment and repeal of Sections 452 and 462 of the Internal Revenue Code of 1954, dealing, respectively, with deferral of prepaid income and deductions of reserves for estimated expenses, as well as the history of recent attempts by particular classes of taxpayers (including membership corporations like the instant taxpayer) to obtain legislative exceptions in their favor, confirm the wisdom of leaving to Congress the creation of exceptions to the annual accounting rule.

During the taxable years here involved, the taxpayer not only had the right to receive annual dues from its members, but actually received them without restriction as to their disposition. The liability of

the taxpayer to render services to its members in exchange for the dues collected was entirely contingent upon the future needs and demands of its members. Moreover, a substantial portion of the expenses of performance was not actually incurred, *i.e.*, the liability to pay concededly did not become fixed, until a later taxable year. Nevertheless, in computing its annual taxable income, taxpayer allocated ("deferred") a percentage of its gross income from membership dues to a subsequent taxable year in order to reflect its contingent liability to perform future services. Its method of computation plainly violated established principles of tax accounting. The diminution of gross income by a reserve for contingent liabities, even though such liabilities stem from or are related to the transaction which produced the gross income, has been specifically disapproved by this Court. *Brown* v. *Helvering, supra.* For federal income tax purposes, and from a revenue standpoint, allocation of part of the gross income to a subsequent taxable year in order to reflect contingent liabilities accomplishes the same proscribed result.

Under a familiar corollary of the annual accounting rule—the so-called claim of right doctrine—a taxpayer who receives money under a claim of right and without restriction as to its use is required to report it as gross income in the year received, even though he is contingently obligated and is in fact required to refund the money in a later year. *E.g., United States* v. *Lewis,* 340 U.S. 590; *Healy* v. *Commissioner,* 345 U.S. 278. Since a contingent obligation to re-

store the very income received does not relieve the recipient taxpayer of a duty to report the income in the year of receipt, an obligation to perform future services in consideration of the income received does not suffice. Only when the expenses of performance are actually incurred—*i.e.*, only in the year when the liability to pay becomes fixed in fact and amount—will the taxpayer be entitled to offsetting deductions. *Security Mills Co.* v. *Commissioner, supra; Brown* v. *Helvering, supra.*

Nothing in the taxing statute or the controlling decisions supports taxpayer's contention that the federal income tax is imposed on "earned" income, whatever that elusive term may signify. The tax applies to the statutory "net income" ("gross income" less allowable "deductions") for a single "taxable year"—not to net income expected over the lifetime of the taxpayer or his business, nor to the overall long-term economic result of a particular contract or transaction, nor even (as the taxpayer here insists) to the net result of operations over a two-year period. The "transactional" approach urged by taxpayer—the "matching" and offsetting of future expenses against "related" current income—is the very antithesis of the annual accounting concept upon which the federal taxing system is erected, and has been expressly rejected by this Court. *Security Mills Co.* v. *Commissioner, supra.* See, also, *Guaranty Trust Co.* v. *Commissioner,* 303 U.S. 493, 498; *Heiner* v. *Mellon,* 304 U.S. 271, 275–276; *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 364–365.

Whether taxpayer's method of accounting is in accord with commercial accounting practice is not controlling. Accounting practices designed to reflect net income in reports to stockholders or creditors are not necessarily suited to the requirements of a tax system. This Court has often held that accepted commercial accounting practices are not determinative of what is proper accounting for purposes of computing federal income tax liability. "Many reserves set up by prudent business men are not allowable as deductions". *Brown* v. *Helvering, supra,* p. 202. See, also, *Commissioner* v. *Hansen, supra; Weiss* v. *Wiener,* 279 U.S. 333, 335. The meaning accorded "net income" by the accounting profession differs significantly from the meaning of that term as used in the Internal Revenue Code and consistently applied by this Court.

II

The taxpayer mistakenly assumes that in *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, this Court, contrary to its repeated holdings in prior cases, sanctioned a departure from the fundamental annual accounting rule and related accrual principles. In *Michigan,* the Court sustained the Commissioner's rejection of a method of accounting virtually identical to that adopted by the taxpayer here. To be sure, in doing so it characterized that taxpayer's method of deferring income from prepaid dues as "artificial"; but, unless the decision is to be construed as a repudiation of all the Court's prior decisions on the subject (a con-

clusion which finds no support in the opinion), the artificiality of the method employed must be deemed a cumulative or independent reason for holding it impermissible for tax accounting purposes.

In addition, we point out that this taxpayer's method of accounting is no less "artificial" than that considered in *Michigan*. As taxpayer's own tabulation of past experience shows, the allocation formula adopted by it was an arbitrary one; the annual membership dues were apportioned in equal monthly amounts, whereas the alleged "related" expenses which it was called upon to incur varied substantially from month to month. That the allocation formula was purely artificial is further attested by the fact that, commencing in 1954, taxpayer changed the formula so as to treat 50 per cent of the dues received at any time during a current year as income accrued in the following year. In the circumstances, the Commissioner clearly did not abuse his discretion in rejecting the accounting method employed by taxpayer, and the court below properly sustained his determination on the authority of this Court's decision in the *Michigan* case.

ARGUMENT

INTRODUCTION

The taxpayer, an automobile club, receives a substantial part of its income from annual membership dues. In exchange, it contracts to provide during the year following receipt, upon a member's demand, various travel and road services. The dues collected from members are received without restriction as to

their use, are deposited in taxpayer's general bank account, and are used for any of its corporate purposes. On its books, however, the taxpayer treated a portion of the dues received as "deferred" income because of future services it might be called upon to render for its members, and in its federal income tax returns for each of the taxable years here involved it reported as gross income only the difference between the amount of dues received in that year and an estimated amount of future expenses it anticipated would be incurred in a later year in performing such services.[1]

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[1] Taxpayer set up on its books a "liability" account designated "deferred revenue", and an "income" account. The dues received were recorded in the "deferred revenue" account, and each month thereafter one-twelfth of the amount in that account was transferred to the "income" account. Only the amount reflected in the latter account was reported as gross income in its tax returns. (R. 63–64.)

The proportion of annual membership dues which taxpayer reflected in its "deferred" revenue account and excluded from the gross income reported in each taxable (calendar) year consisted not only of (1) a corresponding proportion of estimated annual expenses of performing services for its members, but also (2) a corresponding proportion of the excess of annual dues receipts over the estimated annual service expenses (which taxpayer treated as income "earned" in the taxable year from membership dues). To illustrate: if taxpayer received $120,000 of annual membership dues in November of the taxable year 1952, and anticipated incurring $90,000 of service expenses over the membership contract year, it treated two-twelfths ($20,000) of the receipts as "earned" in 1952 and excluded ten-twelfths ($100,000) from 1952 gross income; thus the $100,000 excluded represented not only ten-twelfths of the $90,000 estimated future expenses (or $75,000), but also ten-twelfths of the $30,000 anticipated "earnings" from 1952 membership contracts (or $25,000).

Broadly stated, the question here is whether a taxpayer filing its federal income tax returns on the calendar year-accrual basis may postpone reporting income received in a given taxable year merely because the income represents consideration for services to be performed (or goods to be delivered) in a later year and the taxpayer sets up on its books a contingent liability reserve (here designated a "deferred revenue" account) to reflect an estimated amount of expenses of future performance. The membership dues in question were received by taxpayer without restriction as to their use—the equivalent of economic ownership—and they admittedly constituted "gross income" as defined in Section 22(a) of the Internal Revenue Code of 1939 and comparable Section 61(a) of the 1954 Code (Appendix, *infra*, pp. 1a, 3a–4a). The issue thus is not *whether* the receipts were includible in gross income, but *when, i.e.*, in which taxable year they were includible. The problem may arise in either of two ways: (1) The taxpayer may accrue and report the entire amount received as gross income in the year of receipt, but seek to *deduct* a reserve for contingent liabilities representing the estimated expenses of future performance; or (2) it may seek (as does taxpayer here) to *exclude* from its gross income for the taxable year estimated expenses of future performance.[2]

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[2] See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 62–63 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4694–4695), accompanying Sections 452 and 462 of the Internal Revenue Code of 1954, dealing respectively with "prepaid income" and "reserve for estimated expenses"; S. Rep. No. 372, 84th Cong., 1st Sess., p. 6 (1955-2 Cum. Bull. 858, 861), accompanying the

The taxpayer takes the position (Br. 9, 20–21) that its taxable income from membership dues should be computed on a transactional basis—by "matching" and offsetting against the dues collected in each taxable year an estimated amount of alleged "related" future expenses of performing services for its members, in order to arrive at "earned" income from membership contracts entered into in that year. It is the government's view that under long established principles of federal income tax accounting, repeatedly reaffirmed by this Court, (1) the taxpayer was required to accrue and report as gross income the entire amount of dues received, in the taxable year received; (2) it was entitled to deduct expenses of performing services for its members only in the year when the expenses were actually incurred; (3) it could neither exclude nor deduct from its gross income for any taxable year estimated amounts of future expenses it expected to incur.

In the argument which follows, we deal, first, with the tax accounting problem in its broad aspects (Point I). We set out in Point II our reasons for believing (a) that *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, did not sanction a departure from the annual accounting rule, and (b) that the essential features of the *Michigan* case,

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repeal of those sections by Sec. 1 of the Act of June 15, 1955, c. 143, 69 Stat. 134. The history of the enactment and repeal of Sections 452 and 462 of the 1954 Code, which sheds important light upon the congressional intent in enacting the accounting provisions of the Internal Revenue Code, is discussed *infra*, pp. 44–50.

which was decided in the Commissioner's favor, are not materially different from those presented here.[3]

I

TAXPAYER'S METHOD OF ACCOUNTING FOR ANNUAL MEMBERSHIP DUES RECEIVED, WHEREBY IT POSTPONED REPORTING A PORTION OF THE AMOUNT RECEIVED IN EACH TAXABLE YEAR UNTIL A SUBSEQUENT YEAR IN ORDER TO REFLECT ESTIMATED FUTURE EXPENSES OF PERFORMING SERVICES FOR ITS MEMBERS, VIOLATES SETTLED RULES OF INCOME TAX ACCOUNTING

A. TAXABLE NET INCOME (GROSS INCOME LESS ALLOWABLE DEDUCTIONS) MUST BE COMPUTED AND REPORTED ON AN ANNUAL, NOT A TRANSACTIONAL, BASIS

1. *The annual accounting requirement*

Sections 11 and 13 of the Internal Revenue Code of 1939 impose a tax on the "net income" of individuals and corporations, respectively.[4] Section 21 (Appendix, *infra*, p. 1a) defines "net income" as the "gross

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[3] A problem of accrual accounting is also involved in *United States* v. *Consolidated Edison Co. of New York*, now pending on certiorari, No. 357, this term. There, however, the question does not involve an effort by taxpayer to "match" income and estimated expenditures. The question in *Consolidated Edison* is, when does an item become sufficiently fixed for tax accounting purposes—specifically, whether a payment made in actual discharge of a liability may be deferred because the payor (an accrual basis taxpayer) continues to dispute the liability and is engaged in suing for a refund of the payment.

[4] Since the deficiencies in controversy are for the taxable years 1952 and 1953, and result in part from the disallowance of a claimed net operating loss carryback from 1954, the provisions of both the 1939 and 1954 Codes are applicable. The pertinent provisions of the two Codes, and of the implementing Treas-

income" less allowable "deductions"; Section 22(a) (Appendix, *infra*, p. 1a) defines gross income as including income derived from any source; and Section 23(a) (Appendix, *infra*, p. 1a) authorizes the deduction of ordinary and necessary business expenses, "paid or incurred during the taxable year". Sections 41, 42(a), and 43 (Appendix, *infra*, pp. 2a–3a) require net income to be computed on the basis of an "annual accounting period" (the "taxable year"), in accordance with the method of accounting regularly employed by the taxpayer, provided such method clearly reflects the net income for the taxable year. See also Section 48 (Appendix, *infra*, p. 3a); Sections 39.41–1, 39.41–2, 39.41–3, 39.41–4, 39.42–1, 39.42–4, 39.43–1, 39.43–2 of Regulations 118 under the 1939 Code (Appendix, *infra*, pp. 7a–15a).[8]

For federal income tax purposes, as the Court is aware, the two principal recognized accounting systems are the so-called "cash" and "accrual" methods. Under the "cash" method, gross income is reported in the year of actual receipt and deductions are taken

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nary Regulations under each, are substantially the same in all material respects. However, the provisions of the 1954 Code and Regulations thereunder are more explicit than those of the 1939 Code and Regulations. See Appendix, *infra*, pp. 1a–30a.

[8] The corresponding provisions of the 1954 Code (Sections 61, 63(a), 162(a), 441 (a) through (e), 446, 451(a), and 461(a)), and the corresponding provisions of the Regulations under the 1954 Code (Sections 1.441–1, 1.446–1, 1.451–1(a), 1.451–3, and 1.461–1(a)) are reproduced in the Appendix, *infra*, at pp. 3a–7a, 15a–30a.

in the year of actual expenditure. Under the "accrual" method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not currently receivable, but no later than the year of actual receipt; conversely, deduction items are reported in the year in which they are incurred, *i.e.*, when the liability to pay becomes fixed in fact and amount, even though payment is not then due, but no later than the year of actual payment. Whichever method is adopted must of course be applied consistently. *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Brown* v. *Helvering*, 291 U.S. 193; *Commissioner* v. *Hansen*, 360 U.S. 446; *Spring City Co.* v. *Commissioner*, 292 U.S. 182; *United States* v. *Anderson*, 269 U.S. 422; *Consolidated Edison Co. of New York* v. *United States*, 279 F. 2d 152 (C.A. 2d), certiorari granted, 364 U.S. 890.

The cardinal rule, embodied in Section 41 and often reiterated by this Court, is that the net income must be computed on an annual basis, whether the cash or the accrual method is selected. Neither income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular transaction or group of transactions. *Security Mills Co.* v. *Commissioner*, *supra*; *Brown* v. *Helvering*, *supra*; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359; *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493; *Heiner* v. *Mellon*, 304 U.S. 271.*

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* Although 1939 Code Section 41 provides that the net income shall be computed "in accordance with the method of accounting regularly employed in keeping the [taxpayer's]

The annual accounting rule, and its underlying purpose, were summarized by this Court in the leading *Security Mills* case, *supra*. In that case, a taxpayer on the accrual basis included in its 1935 income processing taxes which it collected as part of the sales price of flour sold to its customers; subsequently, when the tax was held unconstitutional, it reimbursed its customers. In holding that the taxpayer could not deduct the later year's refunds as an offset against its 1935 income, the Court stated (pp. 286–287):

> The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practical to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." [Quoting from *Burnet* v. *Sanford & Brooks*, 282 U.S. at 363.]
>
> This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt

books", this requirement is qualified by the antecedent prescription that the computation be made "upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be)". Taxpayer's suggestion that its method of accounting must be accepted for tax computation purposes because it was "regularly" employed begs the issue; if adopted it would lead to the anomalous result that a taxpayer is relieved of the duty to reflect income on an annual basis simply by disregarding the annual accounting requirement over a number of years, before the Commissioner has audited its returns and challenged its method of accounting.

> or payment, *or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.*
>
> But the petitioner urges that § 43 has altered the rule so that a hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for that of annual accounting periods. * * * The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation. [Emphasis added.]

In *Lewyt Corp* v. *Commissioner,* 349 U.S. 237, the Court again stated (p. 242) that "the concept 'accrued' embodies the annual accounting principle". See, also, *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516. Moreover, in a case involving a taxpayer engaged in the same kind of income-producing activities as the taxpayer here, and using virtually the identical method of accounting, this Court has sustained the Commissioner's disapproval of the taxpayer's accounting method. *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180. See discussion, *infra,* pp. 54–57.

In harmony with this Court's decisions, the lower courts, in a variety of contexts, have insisted upon compliance with the annual accounting rule. See, *e.g., Spencer, White & Prentis* v. *Commissioner,* 144 F. 2d 45 (C.A. 2d), certiorari denied, 323 U.S. 780; *Streight Radio and Television, Inc.* v. *Commissioner,* 280 F. 2d 883 (C.A. 7th), pending on taxpayer's petition for certiorari (No. 507, this Term); *Capital*

Warehouse Co. v. *Commissioner*, 171 F. 2d 395 (C.A. 8th); *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th); *Clay Sewer Pipe Ass'n* v. *Commissioner*, 139 F. 2d 130 (C.A. 3d); *New Capital Hotel* v. *Commissioner*, 261 F. 2d 437 (C.A. 6th), affirming per curiam, 28 T.C. 706. And in a case similar in all material aspects to this one, the Tax Court has likewise insisted upon adherence to the rule. *Automobile Club of New York* v. *Commissioner*, 32 T.C. 906, pending on appeal (C.A. 2d). See, also, *New Jersey Automobile Club* v. *United States*, 181 F. Supp. 259 (C. Cls.), petition for certiorari pending (No. 140, this Term); *Automobile Club of Southern California* v. *United States* (S.D. Cal., decided February 11, 1960, 5 A.F.T.R. 2d 901), pending on appeal (C.A. 9th).'

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[1] In the *Automobile Club of New York* case, *supra*, the Tax Court stated, in part (32 T.C., pp. 911–913):

"This Court has consistently held that the Commissioner has authority to require that prepaid income be reported no later than the year in which it is received, provided such income is subject to unrestricted use by the taxpayer. This rule applies to taxpayers on an accrual basis as well as to those on the cash basis; it applies even though the income may in a sense be regarded as "earned" in a year subsequent to the year of receipt, and even though some systems of accounting in the business world may recognize deferral in such circumstances. * * *

"On an accrual basis of accounting, items of income and deduction may 'accrue' even prior to actual receipt or payment; income is treated as received when the right thereto becomes fixed and deductions are allowable when the liability in respect thereof is unqualifiedly determined. As a practical matter, the income tax laws must operate on an annual basis, and there is no assurance under either an accrual or cash basis of accounting that there will be complete correlation between items of income and deductions pertinent thereto in any given

2. *The transactional method urged by taxpayer*

The taxpayer's method of accounting, on its face, fails to satisfy the annual accounting requirement and related accrual concepts. Instead of accruing and reporting as gross income in each taxable year the entire amount of dues received in that year, and deducting only expenses actually incurred in the same year, it excluded ("deferred") from its gross income an estimated amount of expenses it expected to incur in the succeeding year. Its deferral from the year of receipt to the following year of a portion of its gross income (dues receipts), in order to reflect a reserve for contingent liabilities (estimated amount of future expenses), cannot be squared with this Court's injunction in *Security Mills* (321 U.S. at 286–287) against "allocating income or outgo to a year other than the year * * * in which the right to receive, or the obligation to pay, has become final and definite in amount." Far from reflecting its net income for a single "taxable year" on the basis of gross income actually accrued and liabilities actually incurred within that year, as demanded by the statute and this Court's

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taxable year or that income will always be taxed in the year 'earned'. * * *

"* * * It has not been the practice in tax accounting to enter upon a further inquiry as to whether the income has been "earned" in order to defer the reporting of such income to a later year. The practical difficulties in embarking upon such inquiry and the burden of making the necessary allocations of the amounts of income which, though realized in the taxable year, would have to be charged in part to the taxable year and in part to other years, make clear why no such system has ever been part of the general scheme of our tax laws. * * *"

decisions, taxpayer's returns purported to reflect the net result of its transactions over a period of two taxable years.

In support of its method of accounting, taxpayer contends (Br. 10–11, 19–20) that the federal income tax is imposed upon "earned" income, which it vaguely defines as income remaining after "matching" and deducting "related" future expenses. In substance, taxpayer seeks to cut across its annual accounting periods and employ a "hybrid system, partly annual and partly transactional"—a system which, this Court held in *Security Mills* (p. 287), finds no place in the statutory scheme for computing federal income tax liability.[8] Indeed, the transactional theory advocated

[8] The term "earnings" has never been used in the income tax statutes to describe either the object of the tax or its method of computation. Under the Internal Revenue Code of 1939 the corporate income tax is imposed on the "normal-tax net income", as defined in Section 13, and the "surtax net income" as defined in Section 15. The term "net income" itself is defined in Section 21 as "the gross income computed under section 22, less the deductions allowed by section 23". Section 41 provides that the taxpayer's computation of "The net income" must clearly reflect "the income". The statutory scheme in the 1954 Code is basically the same, except that the term "taxable income" has been substituted for "net income". See Sections 11, 62, 63, 161–175, 241–247, 441, and 446, Internal Revenue Code of 1954. Compare the use of the term "earnings and profits" in Section 115 of the 1939 Code (Section 316 of the 1954 Code), relating to dividend distributions. As the Tax Court observed in *Streight Radio and Television, Inc.* v. *Commissioner*, 33 T.C. 127, 138, affirmed, 280 F. 2d 883 (C.A. 7th):

"Tax accounting does not concern itself with the fine question of whether items have been "earned" in the accounting sense, * * * and this is true whether the item in question has been received, or is merely a receivable."

by taxpayer "proves too much, for under it a taxpayer on the accrual basis could estimate the entire gross income which might be received from his contract [here, membership contracts], though no work had been begun, could deduct the estimated expense of performance and could compute the taxes accordingly". *Spencer, White & Prentis* v. *Commissioner*, 144 F. 2d 45, 46 (C.A. 2d), certiorari denied, 323 U.S. 780. The situation here is essentially no different from any other in which a taxpayer on the accrual basis receives income in one taxable year, out of which expenses or losses will have to be paid in a later year. Under long settled tax accounting principles, the tax on the income in the year of receipt may not be withheld or diminished by excluding or deducting from the gross income a reserve to cover an estimated amount of anticipated expenses or losses.

Basically the same transactional or "earnings" approach advocated by this taxpayer has been rejected by this Court in numerous cases besides *Security Mills* (*e.g.*, *Brown* v. *Helvering*, *supra*; *Burnet* v. *Sanford & Brooks Co.*, *supra*; *Guaranty Trust Co.* v. *Commissioner*, *supra*; *Heiner* v. *Mellon*, *supra*), and by the lower courts (*e.g.*, *Spencer, White & Prentis* v. *Commissioner*, *supra*; *Streight Radio and Television, Inc.* v. *Commissioner*, *supra*; *Capital Warehouse Co.* v. *Commissioner*, *supra*; *Clay Sewer Pipe Ass'n* v. *Commissioner*, *supra*; *South Dade Farms* v. *Commissioner*, *supra*).*

* The Second Circuit's decision in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, typical of the lower courts decisions upon which taxpayer relies, appears irreconcilable with

Thus in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, it was held that compensatory damages received by the taxpayer in 1920 constituted gross income for the taxable year in which received, even though related to expenses incurred and deducted in prior years. In disposing of the taxpayer's argument that the gain or profit subject to tax could be ascertained "only * * * on the basis of particular transactions * * * when they are brought to a conclusion", this Court stated (pp. 364–365):

> Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over

its own decision in the *Spencer, White* case (see also *Commissioner* v. *Fifth Avenue Coach Lines*, 281 F. 2d 556 (C.A. 2d), petition for certiorari pending, No. 634, this Term), and was not followed by the Seventh Circuit in *Streight Radio*, which presented the same issue. But cf. *Milwaukee & Suburban Transport Corp.* v. *Commissioner*, 283 F. 2d 279 (C.A. 7th). We respectfully submit that neither the accounting provisions of the Code nor the controlling decisions of this Court warrant the novel distinction drawn in *Bressner* between "earned" and "unearned" items of gross income for tax accounting purposes. By attempting to "match" gross income received under an executory contract with "related" future expenses of performing the contract, the court in effect applied the proscribed transactional, rather than the prescribed annual, accounting system.

In Rev. Rul 60–85, 1960–1 Cum. Bull. 181, the Internal Revenue Service announced that it would not follow the *Bressner* decision, stating:

"The *Bressner Radio, Inc.*, decision conflicts in principle with a long line of judicial authority holding that where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *"

> deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.
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> * * * * *
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> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The "earnings" approach for which taxpayer contends was again rejected in *Guaranty Trust Co.* v. *Commissioner,* 303 U.S. 493, 498:

> It is true that the acts of Congress taxing income have consistently laid the tax upon the net income received by or accrued to the taxpayer in a "taxable year," which is either the calendar year or a different fiscal year, as the taxpayer may elect. But they have never undertaken to limit the income taxable in any one year to that derived from the taxpayer's activities occurring in that or any other single year. *The items of gross income and of allowed deductions to be included in the income return, are those of the taxpayer for his taxable year, even though they may have resulted from or be*

> *affected by his business transactions of other years. Burnet* v. *Sanford & Brooks Co., supra,* 364, 365. *Circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable, and may thus affect the amount of tax. Receipt of income or accrual of the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it* * * *. [Emphasis added.]

In *Heiner* v. *Mellon,* 304 U.S. 271, the business of two corporations was taken over by two partnerships formed for the purpose of liquidation. The primary question for decision was whether sales profits realized by the two partnerships in 1920 were taxable in that year. The Court said (pp. 275–276):

> Nor is it of legal significance that the liquidation was not completed until 1925 and that until completion of the liquidation it could not be known whether the business venture, taken as a whole, had been profitable. The federal income tax system is based on an annual accounting. Under that law the question whether taxable profits have been made is determined annually by the result of the operations of the year.
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> * * * * *
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> The fact that it might prove that when the business was fully liquidated the profits of 1920 were offset by heavy loss of later years is immaterial. *Losses suffered by a taxpayer in a later year may be deducted from profits, if any, earned by him in that later year; but the tax on a year's income may not be with-*

held because losses may thereafter occur. * * *
[Emphasis added.]

In *Brown* v. *Helvering,* 291 U.S. 193, the Court held that a taxpayer filing his returns on the accrual basis was not entitled to deduct from gross income (insurance commissions) received in the taxable year an amount which his experience for the preceding five years indicated would have to be refunded on account of policy cancellations, since his liability to repay was contingent, not fixed and absolute in that year. The Court stated (pp. 199, 201):

> Under the Revenue Acts taxable income is computed for annual periods. If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is realized even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred. * * *
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> * * * * *
>
> The liability * * * arising from expected future cancellations was not deductible from gross income because it was not fixed and absolute. In respect to no particular policy written within the year could it be known that it would be cancelled in the future year. Nor could it be known that a definite percentage of all the policies will be cancelled in the future years. Experience taught that there is a strong probability that many of the policies written during the taxable year will be so cancelled. But experience taught also that we are not dealing here with certainties. This is shown by the variations in the percentages in the several five-year periods of the aggregate of refunds to the aggregate of overriding commissions.

The taxpayer is here attempting to accomplish what this Court in *Brown* held was not permissible—to offset against gross income for the taxable year an estimated amount of future liabilities based upon taxpayer's experience and attributable to contracts entered into in the taxable year. While this taxpayer seeks to exclude ("defer") an estimated amount from current gross income, instead of deducting it from gross income (as in *Brown*), the net result, from the tax standpoint, is the same under either method. See *Streight Radio and Television, Inc.* v. *Commissioner, supra; South Dade Farms* v. *Commissioner, supra; Automobile Club of New York* v. *Commissioner, supra.*[10]

United States v. *Anderson*, 269 U.S. 422, upon which taxpayer relies (Br. 25), does not support its position. The Court there sustained the Commissioner's determination that a tax imposed on profits from munitions manufactured in 1916 should have been deducted from gross income in that year, even though it was not due and payable until 1917, because (pp. 440–441) "all the events" had occurred in 1916 to "fix the amount of the tax and determine the liability of the taxpayer to pay it".[11] As was pointed out by

[10] See also H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955–2 Cum. Bull. 852, 854), accompanying the repeal of Sections 452 and 462 of the Internal Revenue Code of 1954, discussed *infra*, pp. 48–50.

[11] The Court also approved T.D. 2433, 19 Treasury Decisions, Internal Revenue 5 (1917), as a correct interpretation of Section 13(d), Revenue Act of 1916, c. 463, 39 Stat. 756. In that section, Congress for the first time provided that a return might be made in accordance with a taxpayer's books of account. T.D. 2433 limited the accrual of reserves for tax pur-

the Second Circuit in *Spencer, White & Prentis* v. *Commissioner, supra* (p. 47):

> The petitioner's reliance upon *United States* v. *Anderson*, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347, is misplaced. There the deduction of certain estimated tax liabilities set up in a reserve entered on the taxpayer's books in accordance with a Treasury Regulation was allowed, though the taxes had not been assessed. But all the events had occurred which determined the liability to pay the tax. Here liability for the work done after * * * [the taxable year] had not been incurred for the work had not been performed. * * *[11a]

The transactional or "earnings" theory of tax accounting urged by taxpayer ignores the rationale of the annual accounting rule, to say nothing of the rule itself. As pointed out in *Sanford & Brooks, supra,* and again in *Security Mills,* the annual accounting system is rooted in strong practical and policy considerations—the need of the United States for an ascertainable amount of revenue at regular intervals,

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poses to reserves for liabilities actually "incurred" during the taxable year; reserves for contingent liabilities were expressly disapproved. It further provided that "in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis".

[11a] Note, also, that in *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, which stressed the applicability of the annual accounting rule to taxpayers reporting on the accrual basis, this Court cited its *Anderson* decision for the following proposition (p. 519): "It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid".

collectible through a system capable of practical operation.

By requiring an accrual basis taxpayer to report gross income when the right to receive it becomes fixed, and to deduct liabilities when all the events have occurred which fix both the fact and amount of the liability, the annual accounting system permits the taxpayer to compute, and the Commissioner to assess, the tax on the basis of facts rather than estimates. Moreover, these standards apply uniformly to accrual basis taxpayers in all types of business situations. The transactional or earnings approach, on the other hand, would place on the Commissioner the enormous burden of evaluating and verifying complex statistical evidence submitted by millions of taxpayers in an endless variety of business contexts to prove that they have reliably "related" and "matched" present income with estimated future expenses, or present expenses with estimated future income.[12] Revenue agents will not only become involved in technical accounting problems in order to determine the validity and accuracy of the taxpayer's estimates in the first instance, but will be obliged to re-audit the taxpayer's accounts in later years to ascertain whether subsequent business experience corresponds with the taxpayer's previous estimates. And in cases where there is a variance between prior estimates and subsequent experience, adjustments of the resultant understate-

[12] See Schapiro, *Tax Accounting for Prepaid Income and Reserves for Future Expenses*, Tax Revision Compendium, submitted to the Committee on Ways and Means (1959), Vol. 2, pp. 1133, 1142–1145.

ment or overstatement of actual "earnings" in earlier years, as well as adjustments of the taxpayer's current estimates to assure that past errors will not be perpetuated, will become necessary. Moreover, by offsetting against current income estimated future expenses, the taxpayer may effectively postpone the collection of tax until a later period without any guarantee that tax rates will be the same or that he will later be able to pay the tax."[13]

Adoption of the transactional or "earnings" approach would also pose difficult problems for the courts. It would invite litigation as to whether particular items of income and expense are sufficiently "related" to justify their being "matched", either by a deferral of income or the accrual of a reserve for estimated expenses; and, even if there is a discernible relationship between such items, as to whether the tabulations and ratios submitted by the taxpayer, or those prepared by revenue agents, more accurately

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[13] While the instant case involves an attempt to employ a transactional method of accounting in order to "defer" to the next taxable year a portion of prepaid income (dues) received under one-year membership contracts, the difficulties inherent in applying such a method would of course be magnified in cases where, for example, the taxpayer chooses to sell 5-year or even lifetime membership contracts, or in cases involving prepaid compensation, royalties, rent, etc. covering several years or indefinite periods. Moreover, if taxpayer's transactional accounting theory were adopted, the "deferred" portion of the prepaid income received in such cases would not only be increased, but the taxable year to which such portion would be allocated would be postponed beyond the succeeding year and far into the future. Cf. *Schlude* v. *Commissioner*, 283 F. 2d 234 (C.A. 8th), petition for certiorari pending, No. 629, this Term.

reflect that relationship. The courts would thus inevitably become embroiled in accounting controversies far more numerous, complex, and time-consuming than those they are now called upon to decide under the annual accounting rule.

3. *The claim-of-right doctrine*

It is settled, as a familiar corollary of the annual accounting rule, that a taxpayer (whether on the cash or accrual basis) who receives income under a claim of right and without restriction as to its use must report it in the year received, even though he may later be required to restore the income. *North American Oil* v. *Burnet,* 286 U.S. 417; *United States* v. *Lewis,* 340 U.S. 590; *Healy* v. *Commissioner,* 345 U.S. 278. See also *Rutkin* v. *United States,* 343 U.S. 130.[14]

We agree with taxpayer (Br. 27–30) that the so-called claim of right doctrine is not directly applicable here, since the income in question—membership dues—admittedly belonged to taxpayer and there was never any dispute as to its right to receive or keep the income. See dissenting opinion of Mr. Justice

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[14] As was stated in *United States* v. *Lewis,* 340 U.S. at 592:

"Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I.R.C., §§ 41, 42; and see *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 363. The 'claim of right' interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer."

Harlan in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 191–192. However, we submit that the doctrine and its rationale lend strong support to the government's position. Since the annual accounting rule requires a taxpayer who receives *disputed* income under a claim of right and without restriction as to its use to report it in the year received, notwithstanding that he may later be required to *refund* the very income received, it would seem to follow that a taxpayer must report *undisputed* income in the year received even though he may later be required to *use* some or all of it to meet alleged "related" expenses. See *Streight Radio and Television, Inc.* v. *Commissioner, supra; Spencer, White & Prentis* v. *Commissioner, supra; South Dade Farms* v. *Commissioner, supra; Capital Warehouse Co.* v. *Commissioner, supra; Clay Sewer Pipe Ass'n* v. *Commissioner, supra.* In the case of a taxpayer who is required to repay income received in a previous taxable year, the amount repaid is deductible only in the year in which the liability to repay becomes fixed. *United States* v. *Lewis, supra.* Similarly, in the case of a taxpayer who is required to incur expenses attributable to or in consideration of income received in a prior year, the expenses are deductible only in the year in which the liability to pay them becomes fixed. *Security Mills, supra; Brown* v. *Helvering, supra; United States* v. *Anderson, supra; Dixie Pine Co.* v. *Commissioner, supra.*

4. *Commercial accounting practices*

There is no warrant for taxpayer's assumption (Br. 16–22) that the annual accounting rule and related

accrual concepts laid down by this Court in federal income tax cases must yield to commercial (non-tax) accounting principles. It has often been emphasized that generally accepted commercial accounting practices are not controlling for purposes of computing federal income tax liability. *Brown* v. *Helvering, supra; Security Mills, supra; Lucas* v. *American Code Co.*, 280 U.S. 445; *Bazley* v. *Commissioner*, 331 U.S. 737, 741; *Commissioner* v. *Hansen*, 360 U.S. 446. Even accounting methods prescribed by federal regulatory agencies to insure compliance with other federal statutes are not determinative of tax liability under the Revenue Acts. *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 562; *Mine Hill & Schuylkill Haven R. Co.* v. *Smith*, 184 F. 2d 422 (C.A. 3d), certiorari denied, 340 U.S. 932; *Kansas City Southern Ry. Co.* v. *Commissioner*, 52 F. 2d 372, 378 (C.A. 8th), certiorari denied, 284 U.S. 676. What constitutes a fair and accurate statement of a taxpayer's income in a report to creditors or stockholders, or even for purposes of complying with some other statute, does not necessarily coincide with what must be reported as income under the taxing statute; each report is designed to serve discrete needs and objectives.

Thus, in *Commissioner* v. *Hansen*, 360 U.S. 446, this Court recently held that an automobile dealer was not entitled to exclude from its gross income a "dealer's reserve", representing a portion of the sales price withheld by finance companies, even though it was the "common pattern" (p. 448) and "consistent practice" (p. 452) in the trade to treat such reserves as unac-

crued and unearned until paid over to the dealer. "Many reserves set up by prudent business men are not allowable as deductions". *Brown* v. *Helvering, supra,* 291 U.S. at 202. As the Court stated in *Weiss* v. *Wiener,* 279 U.S. 333, 335: "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. * * *"

It is noteworthy that for general business purposes the accounting profession has ascribed a meaning to "net income" which differs significantly from the meaning of that term as used in the Internal Revenue Code and consistently applied by this Court. The term has been defined by the American Institute of Accountants as synonymous with "earnings" over a "period of years", and as having reference, moreover, to "the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period".[15] Such a transactional or "earnings" method of accounting, although it may serve useful business purposes, is com-

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[15] The American Institute of Accountants, in its Accounting Terminology Bulletin No. 2, pp. 3–4 (March, 1955), defines "net income" as follows:

"The terms *net income* or *net profit* refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period.

* * * * *

"The term earnings is not used uniformly but it is generally employed as a synonym for 'net income,' particularly over a period of years. * * *"

pletely at odds with the annual accounting rule which (as this Court has many times held) is the cornerstone of the federal income tax system. Furthermore, the transactional method of arriving at "net income", approved by the accounting profession for commercial accounting purposes, entails allocations of "charges and credits" which are "estimated" and are "based on assumptions as to future events which may be invalidated by experience"[16]—an approach opposed to the principle that, for federal income tax accounting purposes, a liability may not be accrued and deducted from gross income unless and until it becomes fixed both in fact and amount. *Security Mills, supra; Brown* v. *Helvering, supra; United States* v. *Anderson, supra; Dixie Pine Co.* v. *Commissioner, supra.* As was acknowledged by Professor Paton, the taxpayer's principal witness, there is considerable difference of opinion within the accounting profession itself as to the standards to be applied, even for commercial accounting purposes, in determining what items of expense or other contingent liabilities should be attributed to and offset against cur-

[16] As stated by the American Institute of Accountants in its Accounting Research Bulletin No. 43, p. 59 (1953):

"Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions, they sometimes are large in relation to the other amounts in the income statement."

rent revenue in order to reflect "earned" income." See, also, Schapiro, *Tax Accounting for Prepaid Income and Reserves for Future Expenses;* Tax Revision Compendium, submitted to the Committee on Ways and Means (1959), Vol. 2, pp. 1133, 1142–1143; Recommendations to Congress by the American Institute of Accountants regarding *Divergencies Between Rules of Tax Accounting and Generally Accepted Accounting Principles,* 97 Journal of Accountacy 93 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 62–63, quoted at footnote 23, pp. 46–47, *infra.*

The taxpayer stresses (Br. 16, 31) the provision in Section 39.41–2(a) of Regulations 118 under the 1939 Code that "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." This is hardly an unqualified approval of all commercial accounting practices. Moreover, the corresponding Regulations under the 1954 Code, which elaborate those promulgated under the 1939 Code and also incorporate judicially approved tax accounting principles, carefully explain that the accounting method used by the taxpayer will be acceptable only "if it accords with generally recognized and accepted *income tax accounting principles* and is consistently used by the taxpayer from year to year." Regula-

[17] For example, Professor Paton stated (R. 47) that "in the field of determining the cost assigned to the volume of sales or services rendered, we do have a lot of difficult accounting questions". He also testified (R. 45) that whereas the measure of revenue at the top of an income statement is "a relatively simple thing," the "determination of the costs that are properly applicable to that revenue is a much more controversial subject".

tions § 1.446–1(c) to (ii), Appendix, *infra*, pp. 19a–20a. (Emphasis added.) [18]

Furthermore, Rev. Rul. 60–85, 1960–1 Cum. Bull. 181–182, which is addressed to the very problem here presented, specifically provides that:

> where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. * * *
>
> Accordingly, the Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, such as prepaid royalties, rent, bonuses, etc., regardless of whether the period of proration is definite or indefinite, unless a different treatment is specifically provided in the Internal Revenue Code of 1939 or 1954 or the regulations thereunder.

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[18] This portion of the Regulations under the 1954 Code provides, in part, as follows:

"(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. * * *"

B. CONGRESS HAS AUTHORITATIVELY REJECTED THE METHOD OF ACCOUNTING WHICH TAXPAYER URGES UPON THE COURT

1. *Statutory exceptions to the annual accounting rule*

Before turning to the specific history which shows that Congress has rejected the approach urged by taxpayer—has, indeed, rejected it in the same context in which the matter is presented here—we point out that Congress has long been aware of the rigid requirements of the annual accounting rule and that it has made explicit statutory exceptions in those instances in which it has deemed relief appropriate.[19] Among the special provisions which it has enacted are the following: Section 44 of the Internal Revenue Code of 1939, and Section 453 of the Internal Revenue Code of 1954 (installment sales); Section 122 of the Internal Revenue Code of 1939, and Section 172 of the Internal Revenue Code of 1954 (net operating loss deduction); Section 23(k) of the Internal Revenue Code of 1939, and Section 166 of the Internal Revenue Code of 1954 (bad debt reserves); Sections 201(c)(2) and 202 of the Internal Revenue Code of 1939 (credit for estimated liability reserves of life insurance companies); Sections 802, 803(b) and 804(a), Internal Revenue Code of 1954 (deduction for estimated liability reserves of life insurance companies); Sections 204(b) (6) and (7), (c) (1) and (4), Internal Revenue Code of 1939, and Sections 832(b) (5) and (6), (c) (1) and (4), Internal Revenue Code of 1954 (definitions of "losses incurred" and "expenses incurred"

[19] See the comment in the concurring opinion below, R. 57–58.

with respect to deductions allowed insurance companies other than life and mutual); Section 461(c), Internal Revenue Code of 1954 (proration of real property taxes related to a definite period of time); Section 171, Internal Revenue Code of 1954 (amortizable bond premium); Sections 1301–1307, Internal Revenue Code of 1954 (long-term compensation).[20] See, also, the exception expressly authorized in the long-standing Treasury Regulations with respect to long-term contracts. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 366; Regulations 118, Section 39.42–4 (App., *infra*, pp. 12a–13a); Regulations under the Internal Revenue Code of 1954, Section 1.451–3 (App., *infra*, pp. 26a–28a).

Of the above provisions, Section 122 of the 1939 Code (1954 Code Section 172) provides an apt and familiar illustration. The provisions of that section authorize, with certain limitations, the carry-back or carry-over of net operating losses. (We note parenthetically that taxpayer rests upon this section (see R. 53–54) in seeking to carry back to 1952 and 1953 a claimed net operating loss for 1954.) As this Court commented in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, 386: "Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like

[20] An additional exception, relating to income deferral by publishers, is discussed *infra*, p. 52.

an average taxable income computed over a period longer than one year."[21]

The taxpayer in the instant case is attempting to go far beyond the net operating loss carry-back exception to the annual accounting rule. It simultaneously seeks to exclude from its gross income for the earlier year a reserve for future expenses. As we point out immediately below, an exception of this kind was authorized by Congress for a brief period and then disapproved.

2. *The enactment and repeal of 1954 Code Sections 452 and 462*

Sections 452 and 462 of the Internal Revenue Code of 1954 were designed to authorize, with specified limitations, essentially the same kind of transactional method of accounting which the taxpayer now asks

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[21] A "net loss" carry-back or carry-over provision appeared for the first time in Section 204 of the Revenue Act of 1918, c. 18, 40 Stat. 1057. Its express purpose was to relieve taxpayers from the harshness of the annual accounting system. As stated in the Committee Report (S. Rep. No. 617, 65th Cong., 3d Sess., p. 7) (1939–1 Cum. Bull. (Part 2) 117, 121–122):

"One of the most important provisions inserted by the committee is quite new to our tax laws. At the present time no recognition is given to net losses; that is, if in any year the losses and expenses of a taxpayer exceed his gross income the excess (or in other words, the net loss) can not be carried over into the next year. *For purposes of taxation the settlement must be made upon the basis of each year's business by itself.* The chief merit of the present plan is its simplicity of administration. But it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice. * * * (Emphasis added.)

this Court to sanction. The provisions of those sections and the Committee Reports accompanying their enactment unmistakably show a Congressional understanding that no such method was permissible under existing law, and the repeal of those sections, shortly after enactment, shows no less clearly a purpose to revert to preexisting tax accounting rules.

As enacted in 1954, Section 452 provided that an accrual basis taxpayer might defer "prepaid income" over a maximum period of six years beginning with the "taxable year in which such income is received". Significantly, it was provided, for purposes of identifying the year of receipt, that "prepaid income" would be "treated as received during the taxable year for which it is includible in gross income under Section 451 (without regard to this section)", *i.e.*, as receivable in the year in which the *whole sum* would have been returnable if Section 452 had not been enacted.[22] Thus, Congress must have regarded Section 451, considered by itself, as precluding taxpayers, whatever their method of accounting, from reporting income any later than the year in which actually received. This is the only construction of Section 451 that is consistent with the language of Section 452 in general and Section 452(e)(3) in particular. So viewed, Section 452 was not intended as declaratory of existing law, but rather as alleviating the rigors of the annual accounting principle embodied in the general accounting provisions of the Code.

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[22] 1954 Code Section 451 is the successor to 1939 Code Section 42 (Appendix, *infra*, p. 7a).

Similarly, Section 462 provided that an accrual basis taxpayer might deduct "a reasonable addition to each reserve for estimated expenses to which this section applies", but the term "estimated expense" was defined in subsection (d)(1) as a "deduction * * * part or all of which would (but for this section) be required to be taken into account for a subsequent taxable year * * *." Thus, it was Congress' view in 1954 (when it revised the entire Code) that "but for" the relief afforded by Section 462, an accrual basis taxpayer could not, under the accounting provisions of the Code, deduct a reserve for estimated expenses. The Senate Finance Committee Report accompanying Sections 452 and 462 (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 301 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4940) stated:

> Under the 1939 Code, regardless of the method of accounting, with minor exceptions established by regulations or administrative practice, amounts are includible in gross income by the recipient not later than the time of receipt if they are subject to free and unrestricted use by the taxpayer even though the payments are for goods and services to be provided by the taxpayer at a future time. * * *[23]

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[23] The Report further stated (pp. 62–63) (3 U.S.C. Cong. & Adm. News (1954) 4621, 4694–4695)):

"Under present law payments received in advance for the use of property in future years or for services to be rendered in future years are includible in the income of the recipient in the year they are received. This is true regardless of the taxpayer's method of accounting. However, well-established accounting procedure provides that in the case of those on an accrual accounting system payments for rentals, club dues,

The privileges conferred by Sections 452 and 462 were limited in various ways in order to guard against undue loss of revenue and possible abuses by taxpayers seeking to take advantage of the new provisions. Thus, Section 452 established a maximum of six years over which income might be deferred. In addition, provisions were inserted to deal with situations where the liability (with respect to which income could be deferred) was of "indefinite" duration, or extended beyond the six-year period, or terminated prior to the inclusion in gross income of amounts previously deferred. Similarly, Section 462 provided for adjustments of "excessive" reserves.

These limitations, however, proved inadequate. In 1955, the Treasury recognized that it was encountering a myriad of enforcement problems, with taxpayers

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warehouse fees, and the like should be included in income in the year in which the income is earned and in the year in which the related expenses are incurred. This is not necessarily the year of receipt.

"The House and your committee's bill permit accrual-basis taxpayers to defer the reporting of advance payments as income until the year, or years, in which, under the taxpayer's regular method of accounting, the income is earned. * * *

* * * * *

"Under present law deductions for expenses and losses incurred by a taxpayer may be taken only when all events have occurred which fix the fact and the amount of the taxpayer's liability. This, in many cases, is at variance with generally accepted accounting principles which require all determinable liabilities relating to reported income to be taken into account.

"The House and your committee's bill conform the tax treatment of expenses more closely to general business treatment by permitting an accrual-basis taxpayer to deduct reasonable additions to reserves for estimated expenses. * * *"

over-estimating future expenses and threatening litigation as to the extent of the deferral and reserves permitted. House Hearings, Ways and Means Committee, Prepaid Income and Reserves for Estimated Expenses, on H.R. 4725, 84th Cong., 1st Sess., pp. 1, 3–4, 6, 10–11, 32, 34–35. As a consequence of these practical difficulties, and the anticipation of ensuing revenue losses far in excess of those contemplated at the time of enactment,[24] Sections 452 and 462 were repealed by the Act of June 15, 1955, c. 143, 69 Stat. 134, Section 1. The Committees of both Houses indicated that the subject was to be studied further with a view to the "early" enactment of "definite" legislative rules dealing with income deferral and the accrual of estimated reserves. S. Rep. No. 372, 84th Cong., 1st Sess., p. 6 (1955–2 Cum. Bull. 858, 861); H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955–2 Cum. Bull. 852, 854).

At the time that repeal of Sections 452 and 462 was being considered, the American Automobile Association (taxpayer in the case at bar) appeared at the Congressional hearings and suggested that Section 452 ("PREPAID INCOME") be retained even if Section 462 ("RESERVES FOR ESTIMATED EXPENSES") were repealed. House Hearings, Prepaid Income and Reserves for

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[24] As stated in H. Rep. No. 293, 84th Cong., 1st Sess., p. 3 (1955–2 Cum. Bull. 852, 854):

"Last year when these provisions were enacted it was estimated by the Treasury Department that the total revenue loss involved in all of the accounting provisions was $47 million. From incomplete information now available it appears that the loss from these two provisions alone may well exceed $1 billion. Your committee believes that this is a loss which the Nation can ill afford at this time."

Estimated Expenses, on H.R. 4725, 84th Cong., 1st Sess., pp. 173–176. This proposal was expressly rejected by Congress for the reason that taxpayers could accomplish the same result under Section 452 by deferring income, as they could under Section 462 by deducting estimated expenses.[25] As stated in the report of the House Ways and Means Committee, accompanying repeal (H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955-2 Cum. Bull. 852, 854–855):

> Proposals have been advanced that the income-deferring provisions of section 452 should be retained in the law even though the estimated expense provisions of section 462 are repealed. It is contended that the revenue loss from section 452 is relatively insignificant in relation to the loss involved in section 462. * * * It has been advised by the Treasury, however, that if section 452 is not repealed at the same time section 462 is repealed, a number of taxpayers who have reported a greatly reduced tax liability by electing the benefits of section 462 would be able to accomplish the same result by electing to defer income under section 452. For example, under section 462 it is possible to set up a reserve for estimated expenses attributable to fulfilling obligations of servicing and repairs under a product guaranty. If section 462 only

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[25] Representatives of the television service industry also appeared at these hearings, urging the retention of Section 452, so as to permit the deferral of income with respect to television service contracts extending beyond the close of the taxable year. House Hearings, Prepaid Income and Reserves for Estimated Expenses, on H.R. 4725, 84th Cong., 1st Sess., pp. 140–143, 266–267.

were repealed, it would be possible for taxpayers, simply by changing the form of the transaction, to defer under section 452 that portion of income from the sale of the product which is attributable to the liability for future servicing and repairs under the guaranty. It is, therefore, deemed necessary to repeal section 452 as well as section 462.

In connection with the repeal of 1954 Code Sections 452 and 462, the Treasury confirmed the understanding of the House Ways and Means Committee that the repeal would "operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462 had never been enacted." Letter from Secretary of the Treasury Humphrey to Chairman Cooper, March 22, 1955, reproduced in H. Rep. No. 293, *supra*, p. 5 (1955–2 Cum. Bull., p. 855).

3. *Subsequent unsuccessful attempts to obtain legislative approval of taxpayer's method of accounting*

The taxpayer has sought, on four separate occasions, legislation which would sanction the transactional method of accounting for which it here seeks judicial approval. Congress has not seen fit to grant its approval.

The first unsuccessful attempt occurred in 1955 when, as previously noted, taxpayer proposed that Congress retain Section 452 permitting "deferral" of income, even though it repealed Section 462 permitting the accrual of estimated reserves.

Another effort was made in 1956 by the introduction of H.R. 10833, 84th Cong., 2d Sess., which would have permitted "deferral" with respect to three classes of income—specifically, "prepaid" newspaper and periodical subscriptions, "prepaid" rent, and "prepaid" dues and fees received from members by "nonprofit service organizations." The bill was referred to the Committee on Ways and Means but was never reported out, Congress having in the meantime adjourned. Thereafter, at hearings held in November, 1956, the representatives of the American Automobile Association appeared and made the following recommendation (Hearings before a Subcommittee of the House Ways and Means Committee, Technical Amendments to the Internal Revenue Code, 84th Cong., 2d Sess., p. 308): [26]

> 1. We join the American Institute of Accountants, and the other witnesses who have appeared before you, in recommending to this subcommittee the prompt reenactment of section 452 of the Internal Revenue Code of 1954 on a modified basis.
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> 2. The new section 452 should be specific, rather than general, in order that you will know what items are covered and in order that you can estimate the income involved, insofar as the scope of its application is concerned; and should apply at least to prepaid rents, prepaid subscription income, and prepaid dues and fees received from members by organizations whose

[26] Similar recommendations were made by the representative of the National Committee on Federal Taxation. See House Hearings, *supra*, p. 414.

> principal activity is providing services to its members.

In 1958, Congress enacted Section 455 of the Internal Revenue Code of 1954,[27] permitting the deferral of "prepaid subscription income"—a provision which settled the issue of income deferral with respect to publishers. See *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 697 (C.A. 10th), reversing 21 T.C. 610; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S., p. 189, fn. 20. During the course of the Senate debate on this exception, a proposed subsection (f) was offered in order to provide that the same treatment being accorded publishers be extended so as to cover automobile clubs receiving prepaid dues. In conference, however, the House refused to accept the amendment, and the Senate conferees abandoned it. H. Conference Rep. No. 2632, 85th Cong., 2d Sess., p. 25 (1958–3 Cum. Bull. 1188, 1212). Senator Byrd explained the rejection of the amendment, as follows (104 Cong. Record, Part 14, p. 17744):

> It was the position of the House conferees that this matter of prepaid dues and fees received by non-profit service organizations was a part of the entire subject dealing with the treatment of prepaid income and that such subject should be left for further study of this entire problem. * * *

Finally, as recently as 1960, a similar bill (H.R. 11266, 86th Cong., 2d Sess.), permitting the deferral

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[27] Sec. 28, Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606, 1625.

of "Prepaid Dues Income of Certain Membership Organizations", actually passed the House (on August 24, 1960, 106 Cong. Rec. (Daily Ed.) 16256), but Congress adjourned on September 1, 1960, without taking further action on the measure.

In short, the legislative history and experience surrounding the enactment and repeal of 1954 Code Sections 452 and 462 (dealing with the treatment of prepaid income and reserves for estimated expenses by accrual-basis taxpayers in general), coupled with the history of the several unsuccessful attempts to procure on behalf of automobile clubs special legislative approval of a transactional method of accounting, emphasize the wisdom of leaving to Congress the creation of any exceptions to the established annual accounting rule, and the nature of the limitations and safeguards which should be attached to any such exception in order to protect the revenues. Congress having expressly declined to sanction the transactional method of accounting here urged by taxpayer, both as to accrual-basis taxpayers in general and as to automobile clubs in particular, the court below properly refused to do so. As the Seventh Circuit stated in affirming the Tax Court's decision in a case involving substantially the same issue here presented (*Streight Radio and Television, Inc.* v. *Commissioner,* 280 F. 2d 883, 888, pending on petition for certiorari, No. 507, this Term), "If, instead of a system of annual accounting, a basis of finally ascertained results of particular transactions is to be substituted, Congress and not the courts must provide it."

II

EVEN ASSUMING THAT TAXABLE INCOME MAY BE COMPUTED AND REPORTED ON A TRANSACTIONAL RATHER THAN ON AN ANNUAL BASIS, THE TAXPAYER'S TRANSACTIONAL METHOD OF ACCOUNTING WAS PROPERLY REJECTED BY THE COURT BELOW ON THE AUTHORITY OF *AUTOMOBILE CLUB OF MICHIGAN* v. *COMMISSIONER*, 353 U.S. 180

In *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, this Court sustained the discretionary action of the Commissioner in disallowing a method of accounting virtually identical to that employed by the taxpayer in this case. There, as here, the taxpayer-automobile club (an affiliate of the present taxpayer) allocated an estimated percentage of its gross income from membership dues to the taxable year following the year of receipt, in order to reflect service liabilities which were contingent, both in fact and in amount, upon the future needs and demands of the club's members. This feature led the Court t hold (p. 189) that the taxpayer's method of allocation was "purely artificial" and bore "no relation to the services which petitioner may in fact be called upon to render for the member". As the court below pointed out, the same factor is present in this case, and renders the *Michigan* case controlling.[28]

[28] The Tax Court in *Automobile Club of New York* v. *Commissioner*, 32 T.C. 906, 912, 913; pending on appeal (C.A. 2d), and the District Court in *Automobile Club of Southern California* v. *United States* (S.D. Calif.), decided February 11, 1960 (5 A.F.T.R. 2d 901), pending on appeal (C.A. 9th), have also interpreted *Automobile Club of Michigan* as a rejection by this Court of the method of accounting advanced by the

If, as we contend (Point I, *supra*), taxable net income must be computed and reported on an annual basis, then, of course, *any* transactional method of accounting whereby the taxpayer seeks to exclude or deduct from a current year's income a reserve for estimated future expenses or losses—whether or not such method is otherwise "artificial"—derogates from the annual accounting rule and related accrual concepts, and must for that reason be rejected. And since taxpayer avowedly computed and reported its taxable income on a transactional rather than on an annual basis—by attempting to "match" estimated expenses of performing services for its members in a subsequent year against "related" income from dues received in the taxable year (Br. 10–11, 19–20)—there is no need for any further inquiry as to whether, as taxpayer claims (Br. 39–41), its particular transactional method differed substantially from that considered in *Michigan*.

Because this Court, in *Michigan*, sustained the Commissioner's disapproval of a transactional method of accounting on the ground that it was "purely artificial", the taxpayer assumes that the Court tacitly endorsed the use of transactional accounting methods which are *not* artificial. We submit, however, that the *Michigan* decision was not intended, nor may it properly be viewed, as a repudiation by this Court of all of its prior decisions upholding the annual as

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taxpayer. See, also, *New Jersey Automobile Club* v. *United States*, 181 F. Supp. 259 (C. Cls.), petition for certiorari pending (No. 140, this Term).

opposed to the transactional system of accounting. (See Point I, *supra*.) At most it can be said that the accounting issue in the case (one of several issues presented) went on an independent ground. That the Court did not intend to depart from the fundamental annual accounting rule, and thereby open the door to transactional methods of accounting, is indicated by its reference (pp. 188–189) to the so-called claim-of-right doctrine, a familiar corollary of the annual accounting rule. (See Point I, A, 3, *supra*.)

In any event, as the court below pointed out (R. 56), the method of accounting which the taxpayer employed was "essentially the same method" as was condemned by this Court in *Michigan* (p. 189) as "purely artificial". Accordingly, quite apart from the fact that the method violated the annual accounting rule, it must, on the authority of this Court's *Michigan* decision, likewise be rejected for that reason. Taxpayer's argument on this score (Br. 41–46) points to nothing which in any material respect serves to differentiate its method of accounting from that considered in *Michigan*. It used substantially the same internal bookkeeping system of "deferring" portions of annual membership dues received, and, like the taxpayer in *Michigan*, it admittedly reported as gross income for tax purposes only a portion of the dues received in each taxable year (calendar year), the portion reported being based upon the number of months in the membership-contract year which had elapsed by the close of the taxable year.

Indeed, the very tabulations which taxpayer introduced in evidence demonstrate that its *pro rata* method of allocating each year's membership dues in equal monthly amounts was not in fact "related" to the monthly expenses which it later incurred. The amount of those expenses varied considerably from month to month. During 1953, the average monthly cost per member ranged from a low of $1.06 in November to a high of $1.35 in July—a variation of more than 27 per cent. In 1954, the average monthly cost per member ranged from a low of $0.91 in December to a high of $1.41 in June—a variation of nearly 65 per cent. (R. 70–71.) [29] That the monthly *pro rata* allocation formula used by taxpayer was artificial is accentuated by the fact (R. 53, 65) that, commencing in 1954, taxpayer changed the formula so as to treat half of the dues received as income for the year of receipt, and the other half as income for the following year. Thus, even if we assume for purposes of argument that taxable net income may be computed by matching "related" items of income and expense, without regard to the limitations of the annual accounting rule, it is nevertheless clear that the method of accounting which the taxpayer employed did not accomplish that objective.

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[29] The taxpayer's witness, Arthur I. Cooper, pointed out (Supp. R. 28) that "If income had been recorded in proportion to expenses, * * * we would have reflected an income in 1954 * * * approximately $30,000" more than was actually reflected on the taxpayer's books.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Claims is correct and should be affirmed.

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FEBRUARY 1961.

APPENDIX

Internal Revenue Code of 1939:

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 21.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal

services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be propery accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this chapter—

(a) *Taxable Year.*—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * * * *

(c) *"Paid or Incurred", "Paid or Accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(26 U.S.C. 1952 ed., Sec. 48.)

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

(b) *Cross References.*—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 63. TAXABLE INCOME DEFINED.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

* * * * *

(26 U.S.C. 1958 ed., Sec. 63.)

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

* * * * *

(26 U.S.C. 1958 ed., Sec. 162.)

SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

* *

(a) *Computation of Taxable Income.*—Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) *Taxable Year.*—For purposes of this subtitle, the term "taxable year" means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) the calendar year, if subsection (g) applies; or

(3) the period for which the return is made, if a return is made for a period of less than 12 months.

(c) *Annual Accounting Period.*—For purposes of this subtitle, the term "annual accounting period" means the annual period on

the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar Year.*—For purposes of this subtitle, the term "calendar year" means a period of 12 months ending on December 31.

(e) *Fiscal Year.*—For purposes of this subtitle, the term "fiscal year" means a period of 12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

* * * * *

(26 U.S.C. 1958 ed., Sec. 441.)

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) *Taxpayer Engaged In More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1958 ed., Sec. 446.)

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * * * *

(26 U.S.C. 1958 ed., Sec. 451.)

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * * * *

(26 U.S.C. 1958 ed., Sec. 461.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.41–1 *Computation of net income.* Net income must be computed with respect to

a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42–1 to 39.42–3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 39.41–2 *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in

any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42–2 and 39.42–3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)–5.)

(b) The true income, computed under the Internal Revenue Code, and if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)–1 to

39.22(c)–8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42–4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22 (a)–7 and 39.23(a)–11. Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)–1 to 39.22(d)–7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in §§ 39.44–1 and 39.44–3, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not thereto-

fore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year.

SEC. 39.41–3. *Methods of accounting.* It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and § 39.54–1.) Among the essentials are the following:

(a) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and §§ 39.22(c)–1 to 39.22(c)–8, inclusive);

(b) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(c) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

SEC. 39.41–4 *Accounting period.* The return of a taxpayer is made and his income computed for his taxable year, which in gen-

eral means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding unless, with the approval of the Commissioner, he has changed his accounting period. See § 39.46–1.

SEC. 39.42–1 *When included in gross income—(a) In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41–1 to 39.41–3, inclusive. * * *

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SEC. 39.42–4 *Long-term contracts.* (a) Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section, the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such

contracts may, as to such income, prepare their returns upon either of the following bases:

(1) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(2) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

(b) A taxpayer may change his method of accounting to accord with subparagraph (1) and (2) of paragraph (a) of this section only after permission is secured from the Commissioner as provided in § 39.41–2.

SEC. 39.43–1 *"Paid or incurred" and "paid or accrued."* (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided

in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * * *

SEC. 39.43–2 *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and de-

duction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *

Treasury Regulations on Income Taxes (1954 Code):

§ 1.441–1 PERIOD FOR COMPUTATION OF TAXABLE INCOME.—(a) *Computation of taxable income.*—Taxable income shall be computed and a return shall be made for a period known as the "taxable year." For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see sections 446 to 482, inclusive, and the regulations thereunder.

(b) *Taxable year.*—(1) the Term "taxable year" means—

(i) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(ii) The calendar year, if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies; or

(iii) The period for which the return is made, if the return is made under section 443 for a period of less than 12 months, referred to as a "short period."

(2) A taxable year may not cover a period of more than 12 calendar months except in the case of a 52–53-week taxable year. See § 1.441–2.

(3) A new taxpayer in his first return may adopt any taxable year which meets the requirements of section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including ex-

tensions) for the filing of the return for such taxable year. However, for rules applicable to the adoption of a taxable year by a partnership, see § 1.442–1(b)(2), section 706(b), and § 1.706–1(b). For rules applicable to the taxable year of a member of an affiliated group which makes a consolidated return, see § 1.1502–14 and § 1.442–1(d).

(4) After a taxpayer has adopted a calendar or a fiscal year, he must use it in computing his taxable income and making his returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted under the internal revenue laws or regulations. See section 442 and § 1.442–1. For rules applicable to changes in taxable years of partners and partnerships, see also section 706(b) and § 1.706–1(b).

(c) *Annual accounting period.*—The term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year.*—The term "calendar year" means a period of 12 months ending on December 31. A taxpayer who has not established a fiscal year must make his return on the basis of a calendar year.

(e) *Fiscal year.*—(1) The term "fiscal year" means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52–53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the

taxpayer are kept in accordance with such fiscal year.

* * * * * * *

(g) *No books kept; no accounting period.*—

* * * * * * *

Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books.

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SEC. 1.446–1 GENERAL RULE FOR METHODS OF ACCOUNTING.—(a) *General rule.*—(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

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(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return as, for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on

hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.*—(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods.*—(1) *In general.*—Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.*—Generally, under the cash receipts and

disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451–2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and § 1.461–1 (a)(1).

(ii) *Accrual method.*—Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

(iii) *Other permissible methods.*—Special methods of accounting are described elsewhere in chapter 1 of the Internal Revenue Code and the regulations thereunder. For example, see the following sections and the regulations thereunder; Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.*—(*a*) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(*b*) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.*—(i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the Income Tax Regulations if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the Income Tax Regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) *Taxpayer engaged in more than one business.*—(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used

for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.*—(1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this

section. See also section 446(a) and paragraph (a) of this section.

(2) (i) Except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured, whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxapayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451–3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expense, where material.

(3) In order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application by letter with the Commissioner of Internal Revenue, Washington 25, D.C., within 90 days after the beginning of the taxable year in which it is desired to make the change. The application shall be accompanied by a statement

specifying the nature of the taxpayer's business, his present method of accounting, the method to which he desires to change, the taxable year in which the change is to be effected, the classes of items which would be treated differently under the new method, and all amounts which would be duplicated or omitted as a result of the proposed change. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions and adjustments under which the change will be effected. See section 481 and regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

SEC. 1.451-1 GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.—(a) *General rule.*—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income

for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in the prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706–1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

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SEC. 1.451–3 LONG-TERM CONTRACTS.—(a) *Definition.*—The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted.

(b) *Methods.*—Income from long-term contracts (as defined in paragraph (a) of this section), determined in a manner consistent with the nature and terms of the contract, may be included in gross income in accordance with one of the following methods, provided such method clearly reflects income:

(1) *Percentage of completion method.*—Gross income derived from long-term contracts may be reported according to the percentage of completion method. Under this method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross income for such taxable year. There shall then be deducted all expenditures made during the taxable year in connection with the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in such contract. Certificates of architects or engineers showing the percentage of completion of each contract during the taxable year shall be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(2) *Completed contract method.*—Gross income derived from long-term contracts may be reported for the taxable year in which the contract is finally completed and accepted. Under this method, there shall be deducted from gross income for such year all expenses which are properly allocable to the contract, taking into account any material and supplies charged to the contract but remaining on hand at the time of completion.

(c) *In general.*—Long-term contract methods of accounting apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, such as investment income or expenses not at-

tributable to such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and § 1.446–1(c). A taxpayer may change to or from a long-term contract method of accounting only with the consent of the Commissioner. See section 446(e) and § 1.446–1(e). When a taxpayer reports income under a long-term contract method, a statement to that effect shall be attached to his income tax return.

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SEC. 1.461–1 GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.—(a) *General rule.*—(1) *Taxpayer using cash receipts and disbursements method.*—Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) *Other factors which determine when deductions may be taken.*—(i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his

method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiation of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; and section 165(e), relating to losses resulting from theft.

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